Audited Financial Statements

Universal Care, Inc.

Years ended June 30, 2003 and 2002
with Report of Independent Auditors

Universal Care, Inc.

Audited Financial Statements

Years ended June 30, 2003 and 2002

Contents

ERNST & YOUNG

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Report of Independent Auditors

The Board of Directors and Stockholder
Universal Care, Inc.

We have audited the accompanying balance sheets of Universal Care, Inc. as of June 30, 2003 and 2002, and the related statements of operations, stockholder's equity, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Universal Care, Inc. at June 30, 2003 and 2002, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States.

Ernst & Young LLP

December 3, 2003

Universal Care, Inc.

Balance Sheets

	June 30 2003	June 30 2002
Assets		
Current assets:		
Cash and cash equivalents	**$ 18,429,649**	$ 19,846,650
Investments	**352,011**	322,248
Receivables, net	**21,669,771**	28,257,834
Reinsurance and other receivables	**6,020,837**	4,657,897
Inventories	**1,496,911**	1,382,760
Income taxes receivable and other	**4,367,554**	2,398,940
Total current assets	**52,336,733**	56,866,329
Property, plant and equipment, net of accumulated depreciation and amortization	**21,376,225**	21,228,932
Other assets	**1,172,249**	1,007,527
Deferred income taxes	**1,178,151**	1,178,151
Goodwill and intangible assets, net	**4,650,856**	4,750,856
Total assets	**$ 80,714,214**	$ 85,031,795
Liabilities and stockholder's equity		
Current liabilities:		
Medical claims and benefits payable	**$ 46,591,565**	$ 44,260,880
Accounts payable and accrued expenses	**15,010,706**	14,136,273
Unearned premium revenue	**3,791,097**	5,472,527
Current maturities of long-term debt	**122,567**	863,439
Total current liabilities	**65,515,935**	64,733,119
Long-term debt, less current maturities	**10,851,388**	12,086,350
Other long-term liabilities	**1,362,000**	1,000,000
	12,213,388	13,086,350
Commitments and contingencies		
Stockholder's equity:		
Common stock, $1 stated value:		
Authorized shares – 1,000,000		
Issued and outstanding shares – 26,000	**26,000**	26,000
Additional paid-in capital	**39,400**	39,400
Accumulated other comprehensive income	**122,062**	92,299
Retained earnings	**2,797,429**	7,054,627
Total stockholder's equity	**2,984,891**	7,212,326
Total liabilities and stockholder's equity	**$ 80,714,214**	$ 85,031,795

See accompanying notes.

Universal Care, Inc.

Statements of Operations

	Year ended June 30	
	2003	**2002**
Revenues:		
Group premiums and co-payments	**$443,871,707**	$427,528,770
Fee for service	**4,694,298**	4,294,645
Management fee revenue	**6,647,787**	6,764,344
Other	**110,041**	222,548
Total revenues	**455,323,833**	438,810,307
Expenses:		
Health care services:		
Medical services	**175,948,096**	170,189,887
Participating hospital services	**165,655,941**	159,811,553
Pharmacy and laboratory	**56,431,514**	57,172,757
Other health care expenses	**5,222,386**	1,090,740
Marketing, general and administrative	**56,030,658**	52,297,448
Total expenses	**459,288,595**	440,562,385
Operating loss	**(3,964,762)**	(1,752,078)
Interest income	**431,574**	395,759
Interest expense	**(964,010)**	(933,456)
Loss before income tax benefit	**(4,497,198)**	(2,289,775)
Income tax benefit	**(240,000)**	(989,050)
Net loss	**$ (4,257,198)**	$ (1,300,725)

See accompanying notes.

Universal Care, Inc.

Statements of Stockholder's Equity

	Number of Shares	Common Stock	Additional Paid-in Capital	Accumulated Other Comprehensive Income	Retained Earnings	Total
Balances at June 30, 2001	26,000	$ 26,000	$ 39,400	$ 147,087	$ 8,355,352	$ 8,567,839
Comprehensive income (loss):						
Net loss	–	–	–	–	(1,300,725)	(1,300,725)
Other comprehensive income (loss):						
Unrealized losses on marketable securities, net of tax	–	–	–	(54,788)	–	(54,788)
Comprehensive loss	–	–	–	(54,788)	(1,300,725)	(1,355,513)
Balances at June 30, 2002	26,000	26,000	39,400	92,299	7,054,627	7,212,326
Comprehensive income (loss):						
Net loss	**–**	**–**	**–**	**–**	**(4,257,198)**	**(4,257,198)**
Other comprehensive income (loss):						
Unrealized gains on marketable securities, net of tax	**–**	**–**	**–**	**29,763**	**–**	**29,763**
Comprehensive loss	**–**	**–**	**–**	**29,763**	**(4,257,198)**	**(4,227,435)**
Balances at June 30, 2003	**26,000**	**$26,000**	**$39,400**	**$ 122,062**	**$ 2,797,429**	**$ 2,984,891**

See accompanying notes.

Universal Care, Inc.

Statements of Cash Flows

	Year ended June 30	
	2003	**2002**
Operating activities		
Net loss	**$ (4,257,198)**	$ (1,300,725)
Adjustments to reconcile net loss to net cash provided by operating activities:		
Depreciation and amortization	**2,335,554**	2,395,710
Provision for deferred income taxes	**–**	(799,100)
Changes in operating assets and liabilities, net of effect of acquisition:		
Accounts receivable	**6,588,063**	(8,111,055)
Reinsurance and other receivables	**(1,362,940)**	(1,946,489)
Inventories	**(114,151)**	(28,569)
Income taxes receivable and other	**(1,968,614)**	3,439,829
Medical claims payable	**2,330,685**	15,386,076
Accounts payable and accrued expenses	**874,433**	727,495
Unearned premium revenue	**(1,681,430)**	2,820,465
Net cash provided by operating activities	**2,744,402**	12,583,637
Investing activities		
Purchases of property, plant and equipment	**(2,382,847)**	(2,894,781)
Other long-term liabilities	**362,000**	–
Other assets	**(164,722)**	(223)
Net cash used in investing activities	**(2,185,569)**	(2,895,004)
Financing activities		
Proceeds from issuance of long-term debt	**–**	3,000,000
Payments on long-term debt	**(1,975,834)**	(1,600,832)
Net cash (used in) provided by financing activities	**(1,975,834)**	1,399,168
Net (decrease) increase in cash and cash equivalents	**(1,417,001)**	11,087,801
Cash and cash equivalents at beginning of year	**19,846,650**	8,758,849
Cash and cash equivalents at end of year	**$ 18,429,649**	$ 19,846,650
Supplemental information		
Interest paid	**$ 1,006,977**	$ 933,456
Income taxes paid (refunded)	**$ 1,992,566**	$ (2,711,242)

Universal Care, Inc.

Statements of Cash Flows (continued)

	Year ended June 30 2003	2002
Note payable issued for the acquisition of property	**$ –**	$ 1,540,000
Change in accumulated other comprehensive income	**$ 29,763**	$ (92,899)
Change in deferred income taxes	**–**	38,111
Change in stockholder's equity	**$ 29,763**	$ (54,788)

See accompanying notes.

Universal Care, Inc.

Notes to Financial Statements

June 30, 2003

1. Organization and Summary of Significant Accounting Policies

Organization and Basis of Presentation

Universal Care, Inc. (the Company), a California corporation 100% owned by Howard E. Davis, was incorporated on April 19, 1983, for the purpose of operating a health care service plan (HCSP). On October 15, 1985, the Company obtained state licensure under the Knox-Keene Health Care Services Plan Act of 1975 (Knox-Keene Act), as amended, to operate as a staff model HCSP. On November 1, 1985, the Company purchased Vincent DePaulo, M.D., Inc., a professional medical corporation, and merged with Universal Medical Enterprises, a California corporation, which administered certain other services to the Company.

The Company currently serves approximately 314,000 enrollees, of whom 170,900 are Medi-Cal beneficiaries and 104,300 are commercial beneficiaries. Approximately 43% and 44% of group premiums and co-payments were earned from Medi-Cal beneficiaries in 2003 and 2002, respectively. Approximately 46% and 47% of group premiums were earned from commercial members in 2003 and 2002, respectively. In addition, the Company operates a capitated and a fee-for-service medical practice at its nine health care facilities, 14 dental facilities and two optometry facilities.

On January 21, 1998, Universal Care Health Systems, Inc. (UCHS), a Delaware corporation, was formed to provide certain administrative and other non-medical services to health care providers. On January 21, 2001, the Company transferred certain administrative personnel to UCHS. Howard E. Davis and various family members own UCHS. No consideration was paid for the transfer and no accounting was required. For the period from January 21, 2001 through December 31, 2001, the payroll cost of the former Company administrative personnel was charged by UCHS to the Company at cost.

Effective January 1, 2002, the Company terminated its administrative services arrangement with UCHS and transferred the administrative personnel back to the Company. On January 1, 2002, the Company entered into an administrative services arrangement with an affiliate, Universal Care of Tennessee (UCT), and began providing administrative services to UCT at cost. Effective May 31, 2003, the Company terminated its administrative services agreement with UCT. Management fee revenue earned during 2003 and 2002 totaled $6,647,787 and $6,764,344, respectively. Fees earned in 2003 were reduced by a $2,700,000 write-off of 2003 amounts recognized but subsequently considered uncollectible.

1. Organization and Summary of Significant Accounting Policies (continued)

Recent Operating Results and Liquidity

The Company's loss before income tax benefit of $4,500,000 in 2003, which increased from a loss before income tax benefit of $2,300,000 in 2002, resulted from higher than anticipated medical costs, due in part to a $1,000,000 shortfall in the prior year claims accrual, and a write-off of $2,700,000 of unreimbursed costs incurred under a management fee agreement with UCT, a related party. As a result of continuing losses, the Company has a deficiency in working capital and was in noncompliance with the Knox-Keene Act minimum tangible net equity requirement by $5,400,000. During the period September 30, 2003 to November 11, 2003, the Company's TNE deficiency was corrected and working capital deficiency reduced through a combination of capital contributions in the form of cash and sales of Company stock totaling $8,200,000. The capital contributed exceeded the TNE shortfall at June 30, 2003 by $2,800,000 (see Note 11). The funding, if required, will be provided in cash, secured notes receivable, or real property.

The Company has prepared and submitted to the Department of Managed Health Care a corrective action plan which contemplates that the Company will raise additional capital and streamline operations, as follows:

> Transactions expected to raise additional working capital include: (i) sale of up to nine properties, of which one property valued at $2,370,000 (unaudited) is in escrow, (ii) sale of real property owned by related parties, the proceeds which will be used to pay $4,300,000 of notes received as consideration for stock sold on October 31, 2003 (see Note 11), (iii) cash totaling $3,400,000 received by the Company consisting of capital contributed by Howard Davis and proceeds from stock sales, all during the period October 27, 2003 and November 11, 2003 (see Note 11), and (iv) commitment by Howard Davis to provide up to $3,000,000 of additional working capital, if necessary, through January 1, 2005. The Company has listed for sale three Northern California dental groups, which management believes could provide up to $2,000,000 (unaudited) of cash.
>
> Steps expected to streamline operations include: (i) consolidation of medical group operations, (ii) termination of the under-performing CalPers contract with approximately 20,000 members in January 2003, (iii) fiscal 2004 commercial and Medicare rates increasing on average 12% and 19%, respectively, offset in part by a 5% Medi-Cal rate decrease in Los Angeles County (Orange and San Diego County rates have not changed from fiscal 2003), and (iv) termination of administrative staff and recontracting with existing providers which are expected to result in significant cost reductions.

1. Organization and Summary of Significant Accounting Policies (continued)

Recent Operating Results and Liquidity (continued)

Based on the capital contributed after June 30, 2003, which exceeded the TNE deficiency, the additional capital commitment through January 1, 2005, and the benefits anticipated in 2004 from the corrective action plan, the Company is expected to continue as a going concern. There can be no assurance that the corrective action plan will be implemented as designed nor will generate the anticipated results even if properly implemented.

Revenues and Health Care Services

Prepaid health care premiums from enrolled groups are reported as revenue in the month in which enrollees are entitled to receive health care services. Premiums received prior to such periods are recorded as unearned premium revenue. Revenues from fee-for-service patients are recognized in the period in which the services are rendered, net of applicable contractual allowances.

The Company contracts with various hospitals for the provision of inpatient care services and with various medical groups and independent practice associations (the Contracting Physicians) for the provision of physician services not covered by the staff model offices. The Company compensates the hospitals on a per diem basis and the Contracting Physicians on a capitation or fee-for-service basis. The cost of health care provided is accrued in the period it is dispensed to the enrolled members, based in part on estimates of claims for hospital services, medical specialists, and other health care costs which have been incurred, but not yet settled. Given the inherent variability of such estimates, the actual costs and related liability could differ significantly from the amounts provided which could have a material adverse effect on the Company's results of operations, cash flows, or financial condition in a future period.

As part of a cost control incentive program, the Company provides incentives to Contracting Physicians through the use of risk-sharing arrangements. Payments are made to Contracting Physicians based on their performance in controlling hospital utilization while providing quality health care. Expenses related to the program, which are based in part on estimates, are recorded in the period in which the related services are provided. In the event that hospital utilization exceeds a pre-established budget (Risk Share Deficit), future incentive payments will not be made to the Contracting Physicians until the Risk Share Deficit is fully recovered.

1. Organization and Summary of Significant Accounting Policies (continued)

Revenues and Health Care Services (continued)

The Company purchases reinsurance (stop-loss) coverage for its Commercial and Medicare members to cover unusually high costs of inpatient care (including organ transplants), in excess of $300,000 per member in each contract year through June 1, 2003, subject to an annual per member maximum of $1,000,000. Effective July 1, 2003, the Company renewed its reinsurance coverage for its Commercial and Medicare members to cover inpatient services in excess of $400,000 per member in each contract year, subject to an annual per member maximum of $1,000,000.

Inpatient services provided in Orange County incurred on behalf of Medi-Cal beneficiaries in excess of $100,000 per case and transplant services are reinsured by the state of California. The Company has elected to self-insure inpatient services provided in Los Angeles County and San Diego County incurred on behalf of Medi-Cal beneficiaries. Reinsurance premiums for all providers are included in medical services expense. Reinsurance recoveries are reported in the Company's financial statements as a reduction of medical services expense.

Investments

Investments are comprised of marketable equity securities that are designated as available-for-sale. Accordingly, marketable securities are carried at fair value, as determined based on quoted prices in active markets, and unrealized gains or losses, net of income taxes, are reported as other comprehensive income in stockholder's equity.

The Company is required by state regulatory agencies to set aside funds for the protection of their plan members (included in other assets). At June 30, 2003, such funds included debt securities held by a bank and are designated as held-to-maturity since the Company has the intent and ability to hold such securities to maturity. Held-to-maturity securities are stated at amortized cost, adjusted for amortization of premiums and accretion of discounts to maturity. At June 30, 2002, funds set aside for regulatory purposes were comprised of cash.

Inventories

Inventories, which consist of prescription drugs and supplies, are carried at cost and are determined on the first-in, first-out basis, which is lower than market.

1. Organization and Summary of Significant Accounting Policies (continued)

Goodwill and Intangible Assets

The Company allocates the excess of the purchase price over the fair value of the net assets acquired to goodwill and identifiable intangible assets. Identifiable intangible assets include membership.

In July 2001, the Financial Accounting Standards Board issued Statements of Financial Accounting Standards (SFAS) No. 141, "Business Combinations," and No. 142, "Goodwill and Other Intangible Assets," effective for fiscal years beginning after December 15, 2001. Under the new rules, goodwill is no longer amortized, but is subject to annual impairment tests. The tests for measuring goodwill impairment under SFAS No. 142 are more stringent than previous tests required by SFAS No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of." Under SFAS No. 121, an undiscounted cash flow model was applied to assess the fair value of the Company, which did not result in the recognition of goodwill impairment.

Under the guidance of SFAS No. 142, there was no impairment of goodwill for the year ended June 30, 2003, since our fair value exceeded the book equity value. The following table reflects consolidated results adjusted as though the adoption of the SFAS No. 142 non-amortization of goodwill provision occurred as of the beginning of the year ended June 30, 2003:

	Year ended June 30	
	2003	**2002**
Net loss		
As reported	**$(3,283,154)**	$(1,300,725)
Pro forma	–	(1,138,556)

Goodwill is as follows:

	June 30	
	2003	**2002**
Goodwill	**$ 5,571,866**	$ 5,571,866
Less accumulated amortization (prior to adopting SFAS No. 142)	**(1,079,343)**	(1,079,343)
Total goodwill, net	**$ 4,492,523**	$ 4,492,523

1. Organization and Summary of Significant Accounting Policies (continued)

Goodwill and Intangible Assets (continued)

Intangible assets are as follows:

	June 30 2003	June 30 2002
Covenant-not-to-compete	**$ 534,195**	$ 534,195
Less accumulated amortization	**(375,862)**	(275,862)
Total intangible assets, net	**$ 158,333**	$ 258,333

Under the new rules, intangible assets will continue to be amortized over their useful lives. Amortization expense was $100,000 in 2003 and 2002. The estimated amortization expense for intangible assets will be $100,000 in 2004 and $58,000 in 2005.

Property, Plant and Equipment

Property, plant and equipment are stated at cost, less accumulated depreciation. Depreciation is provided over the estimated useful life of each class of depreciable asset and is computed using the straight-line method. Equipment under capital lease obligations is amortized using the straight-line method over the shorter period of the lease term or the estimated useful life of the equipment. Such amortization is included in depreciation and amortization in the statements of operations.

Long-Lived Asset Impairment

In August 2001, SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets," was issued. SFAS No. 144 supersedes SFAS No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of," effective for fiscal years beginning after December 15, 2001. SFAS No. 144 applies to all long-lived assets (including discontinued operations) and consequently amends APB No. 30, "Reporting the Results of Operations – Reporting the Effects of Disposal of a Segment of a Business and Extraordinary, Unusual and Infrequently Occurring Events and Transactions." SFAS No. 144 develops an accounting model for long-lived assets that are to be disposed of by sale and requires the measurement to be at the lower of book

1. Organization and Summary of Significant Accounting Policies (continued)

Long-Lived Asset Impairment (continued)

value or fair value, less the cost to sell the assets. Additionally, SFAS No. 144 expands the scope of discontinued operations to include all components of an entity with operations that (1) can be distinguished from the rest of the entity and (2) will be eliminated from the ongoing operations of the entity in a disposal transaction. The adoption of SFAS No. 144 on July 1, 2002, had no effect on the Company's financial position, operating results or cash flows.

The Company reviews long-lived assets for impairment when events or changes in business conditions indicate that their carrying value may not be recovered. The Company considers assets to be impaired and writes them down to fair value if expected associated cash flows are less than the carrying amounts. Fair value is the present value of the associated cash flows. The Company has determined that no long-lived assets are impaired at June 30, 2003.

Cash Equivalents

The Company considers all highly liquid debt instruments purchased with a maturity of three months or less and investments in money market accounts to be cash equivalents.

Concentration of Credit Risk

Financial instruments that potentially subject the Company to concentrations of credit risk consist primarily of investments and receivables. All of the investments are managed within guidelines established by the Company's board of directors, which as a matter of policy, limit the investments to U.S. government debt securities, municipal debt securities or certificates of deposit. Concentrations of credit risk with respect to fee-for-service receivables are limited due to the large number of payors comprising the Company's customer base. Concentration of credit risk with regard to the receivable Due from Health Net is limited since amounts are generally paid within 30 days following month-end. As of June 30, 2003, the Company had no significant concentration of credit risk.

1. Organization and Summary of Significant Accounting Policies (continued)

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements. Estimates also affect the reported amounts of revenues and expenses during the reporting period. Actual results could differ from these estimates.

Medical Malpractice Liability Insurance

The Company maintains claims-made medical malpractice liability insurance coverage for all employed physicians up to $5,000,000 in aggregate cost and $5,000,000 cost per claimant (with a $250,000 deductible). Claims-made insurance only provides coverage on those claims reported during the policy period. Accruals for the cost of claims incurred but not reported are estimated by an actuary based upon the Company's claims experience and are discounted at 4.0%. Management intends to obtain medical malpractice liability insurance coverage on a claims-made basis in future years.

Each non-employee physician and contracting hospital is obligated to carry professional liability insurance in the minimum amount required by state law.

Workers' Compensation Insurance

The Company maintains workers' compensation insurance for all employees up to $3,250,000 with an annual deductible of $500,000 per claim. Accruals for the cost of claims incurred but not reported are estimated by an actuary based upon the Company's claims experience. The Company also maintains a Letter of Credit up to $2,000,000 to secure estimated future payment obligations.

Income Taxes

Taxes based upon income are recorded in accordance with SFAS No. 109, "Accounting for Income Taxes."

1. Organization and Summary of Significant Accounting Policies (continued)

Reclassifications

Certain prior year amounts have been reclassified to conform to the current year presentation.

2. Receivables, Net

The following table summarizes premiums receivable:

	June 30 2003	June 30 2002
Premiums receivable	**$ 8,009,833**	$ 10,793,112
Fee for service receivables	**1,496,611**	1,438,075
Premiums receivable, net	**9,506,444**	12,231,187
Due from Health Net	**12,163,327**	16,026,647
Receivables, net	**$ 21,669,771**	$ 28,257,834

The Company is a subcontractor to Health Net, a subsidiary of Foundation Health Plan, to provide health care services to members enrolled in the California Department of Health Services (DHS) Medi-Cal Managed Care Program. Under the contract, Health Net receives payment in the form of capitation from DHS, retaining a portion for its administration costs, and remitting the balance to the Company to cover member health care services. Amounts due from Health Net as of June 2003 and 2002 were received in July 2003 and 2002, respectively. During September 2002, the Company received a $2,834,886 retroactive capitation rate increase from the California Department of Finance for the period July 1, 2001 to June 30, 2002. The capitation rate increase, included in Due from Health Net, had the effect of increasing premium revenues and receivables by $2,834,886 for the year ended June 30, 2002.

3. Investments

The following table summarizes securities:

		Cost		Gross Unrealized Gains		Gross Unrealized Losses		Estimated Fair Value
Available-for-sale securities:								
Equity securities – June 30, 2003	**$**	**170,000**	**$**	**182,011**	**$**	**–**	**$**	**352,011**
Equity securities – June 30, 2002	$	170,000	$	153,935	$	1,687	$	322,248
Held-to-maturity securities (due within one year) – June 30, 2003:								
U.S. government debt securities	**$**	**508,582**	**$**	**1,387**	**$**	**–**	**$**	**509,969**

4. Property, Plant and Equipment

The following table summarizes property, plant and equipment:

	June 30	
	2003	**2002**
Property, plant and equipment:		
Medical and computer equipment	**$ 19,008,595**	$ 16,945,325
Furniture and fixtures	**2,395,735**	2,393,191
Building and leasehold improvements	**13,629,538**	13,266,495
Construction in progress	**–**	46,010
Land	**5,870,887**	5,870,887
	40,904,755	38,521,908
Less accumulated depreciation and amortization	**19,528,530**	17,292,976
Property, plant and equipment, net	**$ 21,376,225**	$ 21,228,932

5. Long-Term Debt

Long-term debt consists of the following:

	June 30	
	2003	**2002**
Subordinated note payable to the Company's stockholder, interest at 10% per annum – refinanced	**$ –**	$ 250,000
Subordinated notes payable to the Company's stockholder, interest at prime (4.00% and 4.75% at June 30, 2003 and 2002, respectively), plus 3.25% – refinanced	–	164,100
Subordinated note payable to the Company's stockholder, interest at prime (4.00% and 4.75% at June 30, 2003 and 2002, respectively), plus 1.75% – refinanced	–	85,417
Subordinated notes payable to the Company's stockholder, interest at 5.25% through February 28, 2005, unsecured	**4,388,374**	5,500,000
Subordinated notes payable to the Company's stockholder, interest at 5.25% through February 11, 2006, unsecured	**499,417**	–
Subordinated note payable to related party, interest only at 5.25% through February 25, 2007, secured by real estate	**1,540,000**	1,540,000
Total subordinated notes payable	**6,427,791**	7,539,517
Notes payable to bank, monthly interest payments at 5.25%, balloon payment of unpaid principal and accrued interest due October 23, 2002, secured by savings account	–	750,000
Note payable to individual, interest at 9%, secured by building, monthly payments of $2,615 of principal and interest through July 14, 2025	**300,532**	304,660
Note payable to bank, interest at 9.04%, secured by building, monthly payment of $5,507 of principal and interest through May 20, 2014	**457,277**	480,978

5. Long-Term Debt (continued)

	June 30	
	2003	**2002**
Note payable to bank, interest at 8.5%, secured by building, monthly payment of $11,325 of principal and interest through February 1, 2018	**$ 1,137,209**	$ 1,174,699
Notes payable to bank, interest at 8.75%, secured by building, monthly payment of $23,763 of principal and interest through March 1, 2008	**2,651,046**	2,699,384
Obligations under long-term capital equipment leases	**–**	551
	10,973,955	12,949,789
Less current maturities	**122,567**	863,439
Long-term debt due after one year	**$ 10,851,388**	$ 12,086,350

The notes payable to the Company's stockholder and officers have been irrevocably subordinated to all other present and future creditors of the Company. The subordination provision of the notes allows the Company to include the outstanding balances in determining minimum tangible net equity pursuant to the Knox-Keene Act.

The Company's stockholder and officers have agreed not to require repayment of certain notes payable totaling $6,427,791 before July 1, 2004. Therefore, the notes payable are included in long-term liabilities.

Maturities of long-term debt are as follows:

2004	**$ 122,567**
2005	**4,522,808**
2006	**931,929**
2007	**1,694,258**
2008	**3,402,404**
Thereafter	**299,989**
	$ 10,973,955

The estimated fair value of the Company's long-term debt approximates its carrying value.

6. Commitments

Future minimum lease payments for all operating leases, including leases with related parties (see Note 7), for office facilities and equipment are as follows:

2004	**$ 1,781,326**
2005	**1,479,224**
2006	**1,194,267**
2007	**1,002,924**
2008	**675,305**
Thereafter through 2013	**4,322,714**
	$ 10,455,760

Rental expense for all operating leases, including leases with related parties (see Note 7), totaled $2,852,000 and $2,698,000 in fiscal 2003 and 2002, respectively.

7. Related Party Transactions

The Company leases certain properties from a related party under a lease with an initial five-year term and three five-year renewal options. Rental expense for the properties totaled $1,170,472 and $857,000 in fiscal 2003 and 2002, respectively.

During fiscal 2002, the Company acquired the Bellflower Medical Clinic from a related party and issued a $1,540,000 subordinated note payable (see Note 5).

8. Income Taxes

The Company's benefit for income taxes is as follows:

	Year ended June 30	
	2003	**2002**
Current:		
Federal	**$ –**	$ –
State	**(240,000)**	(189,950)
	(240,000)	(189,950)
Deferred:		
Federal	**–**	(712,900)
State	**–**	(86,200)
	–	(799,100)
	$ (240,000)	$ (989,050)

The difference between the provision for income taxes and the amount computed by applying the statutory federal income tax rate to income before taxes is attributable to state income taxes, nondeductible expenses, valuation allowances and state tax credits applied for in 2002 and 2003 relating to prior years.

The following table summarizes the tax affects of temporary differences which gives rise to significant portions of the deferred tax assets:

	June 30	
	2003	**2002**
Depreciation and amortization	**$ (79,000)**	$ (363,000)
Unrealized gains on marketable securities	**(77,849)**	(59,949)
State taxes	**(239,000)**	(357,000)
Prepaid expenses	**(397,000)**	(530,900)
Accrued expenses	**1,205,000**	877,000
Tax credits	**489,000**	489,000
Net operating loss carryforward	**1,879,000**	1,123,000
	2,780,151	1,178,151
Valuation allowance	**(1,602,000)**	–
Net deferred tax assets	**$ 1,178,151**	$ 1,178,151

8. Income Taxes (continued)

Due to continuing operating losses during the period 2001 through 2003, a valuation allowance of $1,602,000 was recorded to reserve for tax benefits associated with the 2003 operating losses. Management has not determined that it is more likely than not that the Company's deferred tax assets arising during 2003 will be realized through future earnings. However, management believes that deferred tax assets arising prior to 2003 are more likely than not to be realized through available tax strategies. Accordingly, valuation allowances have been recorded to partially reserve the Company's deferred tax assets as of June 30, 2003.

As of June 30, 2003, the Company has federal and state net operating loss carryforwards of $1,461,000 and $418,000, respectively. The federal net operating loss carryforwards begin to expire in 2023 and the state net operating loss carryforwards begin to expire in 2014.

9. Contingencies

The Company is a party to certain legal actions. In management's opinion, the Company has adequate legal defenses or insurance coverage relating to these actions, and management does not believe that the outcome of any of these legal actions will materially affect the Company's financial position, results of operations, or cash flows.

The Company has been a subcontractor for the Community Health Plan of Los Angeles County (CHP) pursuant to the Healthy Families Program, which is administered by the Managed Risk Medical Insurance Board. The Company has filed a claim against CHP, which is currently in arbitration, for underpayment of $4.7 million in premiums due the Company related to coverage provided to CHP program members. A receivable of $1.6 million at June 30, 2003 and 2002, has been recorded (in reinsurance and other receivables). The difference between the amount recorded and the actual amount received will be reported in earnings as a change in estimate in the period the dispute is resolved.

10. Retirement Plan

The Company participates in a 401(k) retirement plan (the Plan) covering substantially all of its employees. The Company may, at its discretion, make a contribution to the Plan that will match part or all of the employee's contribution. The Company may also, at its

10. Retirement Plan (continued)

discretion, make a contribution to the Plan that is not a matching contribution; this allows eligible employees who have elected not to participate in the Plan to receive a contribution to the Plan on their behalf. Expense under the Plan for fiscal 2003 and 2002 totaled $6,000 and $38,000, respectively.

11. Requirements of Regulatory Authorities

The Knox-Keene Act specifies that the Company must comply with a minimum TNE requirement. Available TNE is defined as the Company's net assets less intangibles and amounts due from affiliates, plus subordinated obligations. At June 30, 2003, the Company's TNE requirement was $10,100,000. The Company's actual TNE was $4,700,000, which did not comply with the minimum TNE requirement.

To correct the TNE deficiency, the Company increased its capital through cash contributions and sales of Company stock as follows:

Capital contributions in the form of cash were made by Howard Davis, stockholder, president and chief executive officer, totaling $3,100,000 as follows: (i) $1,000,000 on September 30, 2003; (ii) $500,000 on October 27, 2003; (iii) $1,598,704 on November 10, 2003; and (iv) $1,296 on November 11, 2003.

Company stock sold for $5,100,950 for consideration in the form of cash and secured notes receivable as follows:

104 shares – Acquired for cash consideration of $300,396 by Jeff Davis, Chief Operating Officer, and Jay Davis, VP Marketing, during the period October 28, 2003 through November 10, 2003.

1,108 shares – Acquired for a secured interest bearing (8%) note receivable of $3,200,269 by Howard and Elaine Davis Grandchildren's Trust on October 31, 2003.

364 shares – Acquired for a secured interest bearing (5.5%) note receivable of $1,051,385 by 1160 Cirby Way Partnership (Cirby). Cirby is owned by Howard and Elaine Davis (20%), Marc Davis (20%), Jeff Davis (20%), Jay Davis (20%) and Laura Davis (20%) on October 31, 2003.

11. Requirements of Regulatory Authorities (continued)

190 shares – Acquired for a secured interest bearing (5.5%) note receivable of $548,800 by Riverside 12th Street Investment Group (Riverside). Riverside is owned by Howard and Elaine Davis (20%), Marc Davis (20%), Jeff Davis (20%), Jay Davis (20%) and Laura Davis (20%) on October 31, 2003.

The notes receivable are secured by a second trust deed in various real estate properties with available equity tangible value of at least 110% of the amount owing (unaudited). Interest is payable quarterly beginning December 31, 2003. Principal and unpaid interest are due on the earlier of (i) the date on which any of the shares are sold, transferred or conveyed, (ii) 10 years from the date of the note, or (iii) the date mutually agreed upon between issuers of the notes and the Company.

Capital contributed in the form of cash and stock sales totaling $8,201,000 exceeded the TNE deficiency at June 30, 2003, by $2,800,000.

The Company is required to file a copy of its audited financial statements with the Department of Managed Health Care within 120 days following its fiscal year-end. The Company was in noncompliance with this filing requirement for the year ended June 30, 2003. Management does not believe that a fine, if levied, will materially effect the Company's financial position, operating results or cash flows.

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